

Comments on Airlines' Responses to the CAA's Final Proposals

CAA/Q6/97

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Non Confidential

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Introduction

This document is a response to the Civil Aviation Authority's (CAA) letter dated 18 November 2013, and is a supplement to Heathrow's main response to the CAA's Final Proposals.

The CAA's letter sought additional views on relevant developments since the publication of the Final Proposals, for example, comments on third-party responses to the Final Proposals and the Competition Commission's (CC) provisional findings on the Northern Ireland Electricity ("NIE") case.

Heathrow's initial comments on the CC's findings are contained at Annex 1 (WACC) and Annex 2 to this response.

Transparency, consultation and engagement are critical to a constructive and informed regulatory review process. Exchange of information and views benefits all stakeholders and it is in passengers' interests if the CAA's thinking is well informed.

In contrast to the airline community, Heathrow has acted constructively and transparently throughout the review process. While the airline community suggests that, "*throughout the process the airline community has maintained full transparency and engagement with 82 airlines*", the airline community has only shared a heavily redacted version of its "Response to the Initial Proposals" and has not disclosed its key submission of 16th August, which is referred to as the airline community's position on opex and supporting their position on WACC. Heathrow has shared all major submissions with the airline community, with minimal redactions, and has engaged with the airlines through the on-going development of Heathrow's capital plans.

Heathrow's comments on responses focus on *new* points or information. In some cases, we offer comments on an existing area of policy where *new* information or analysis is being presented. It is Heathrow's view that, in a number of instances airlines' responses to the CAA's consultation misunderstand the CAA's analysis and proposals, or contain statements and comments which we believe are factually incorrect or misleading.

The airlines are also presenting information and arguments very late in the review process. It is Heathrow's view that these arguments are inherently weak in value given that these "facts" cannot have suddenly materialised. It appears that many of the areas airlines present as fact are instead assertions that have occurred to airlines at a convenient moment in an attempt to distract due process. In this document we set out Heathrow's comments on the AOC's/LACC's, BA's and Virgin's response to the CAA's Final Proposals.

The analysis is non-exhaustive, the fact that we do not offer comment on every element of every third-party submission does not mean that Heathrow agrees with the comments or positions set out in the third-party responses. Moreover, Heathrow's comments must also be considered in the context of our response to the CAA's Final Proposals and our respective business plans, these provide a comprehensive detailed and evidence based view of Heathrow's position.

In taking work forward on Q6 the CAA must rigorously 'test' the submissions and evidence presented by all stakeholders. Where relevant and sufficient evidence is not forthcoming, and where statements are found to be incorrect or inaccurate, the CAA must discount these from its considerations.

Frequent reference is made throughout the responses to Heathrow's assumed SMP and how this influences airlines' view of the settlement. For example, Heathrow's alleged inefficiencies or its policies in respect of capital investment. Set out below are five simple facts based on third party commentary around these and related matters, illustrating the contradictory and sometimes misleading nature of airlines' responses.

FACT 1

On competition, respondents cannot argue that Heathrow is a "monopoly" while indicating at least indirect competition.

BA's response states, "*as the CAA's cost hike affects only Heathrow airlines ... the CAA is effectively putting the airlines that operate from Heathrow at a competitive disadvantage*". Unfortunately, BA's response is not specific and none of the relevant data has been shared with Heathrow. Notwithstanding, in the CAA's context of derived demand¹, BA's statement appears to indicate that Heathrow operates in a wider market and is subject to competitive constraint.

Relatedly, information presented at IAG's recent market day contains a forecast increase of £200m to BA's target operating profit for 2013-15, while noting Q6 airport charges will move with RPI. This does not reconcile with BA's statement that RPI+0% will put airlines at Heathrow at a competitive disadvantage; BA is forecasting an improvement in its margins.

FACT 2

On forecasts, respondents cannot argue that passenger forecasts should increase by ~10m while simultaneously arguing that RPI+0% will materially impact demand and put Heathrow airlines at a disadvantage.

BA's response states that, "*either passengers will have to pay more ... or airlines will have to absorb the costs*". BA goes on to say, "*this could mean fewer routes, older aircraft and products and a less competitive aviation sector at Heathrow*". It is not possible to reconcile these statements with BA's assertion in the same document that, "*... traffic could be higher than our forecast, but at this stage prefer to present a **highly conservative estimate of 372.1m***".

In the event that BA has used a new and fundamentally different forecasting method and/or model to derive the above estimate, this has not been shared with Heathrow. Perhaps expectedly, this data has also been presented very late in the review process.

FACT 3

On capex, respondents cannot argue that Heathrow acted inappropriately in responding to the CAA's price signal (CAA's Initial Proposals).

On the one hand, the BA states, "*[it] was extremely disappointed to witness the disengagement of HAL from the process*", while the AOC/LACC go further, "*the Airline Community continues to be disappointed and frustrated by HAL's capital strike...*".

¹ Chapter 3, CAA's Consultation on Heathrow Market Power Assessment.

On the other hand, BA's response states that any "*commitment to a £3bn plan is predicated on the plan being affordable to British Airways*", i.e. a function of the price and/or overall settlement. This is clearly incoherent.

FACT 4

On opex, respondents cannot argue, in the very general terms used by airlines, that Heathrow is currently "inefficient" or that it will continue to be "inefficient" during Q6.

Virgin's response states "*the CAA's proposals on opex efficiency is neither challenging for HAL nor fair for passengers*", while BA goes further, "*we are particularly disappointed with the low level of challenge that the CAA has set ... the CAA have delivered an insufficiently challenging opex target*".

In common with airlines, Heathrow has successfully driven cost savings during Q5+1 of ~~XXXX~~ resulting in underlying opex per passenger falling by around 1.6% year-on-year. Going forward, Heathrow will drive cost savings on underlying opex at 2.0% year-on-year, representing a cumulative saving of 9.4% by the end of the Q6 period. Heathrow's existing efforts and prospective efficiencies cannot be described as "inefficient", particularly when airlines, despite presenting themselves as the benchmark for efficiencies, are forecasting only modest future (non-fuel) efficiencies themselves.

FACT 5

On returns, respondents cannot argue that Heathrow has been, or will be, "over-rewarded" in the face of evidence to the contrary.

BA's response repeatedly repeats Willie Walsh's assertion that Heathrow is "*over-rewarded, making record profits and attracting investment*". The AOC/LACC response uses very similar language stating that the CAA is "*providing over-generous and insufficiently challenging settlements which over-reward HAL*". Firstly, Heathrow has been prevented from realising the current regulated and allowable return. Cumulatively over the price control period, returns will be ~40% below the allowable level.

Secondly, BA's assertion that Heathrow is making *record* profits is entirely misleading. To the extent profits have been earned at Heathrow, these have been re-invested in the business and in the £5bn of investment undertaken during Q5+1. This is further evidenced by the fact that Heathrow has not paid a regular dividend and the dividend to date equates to marginally more than 1%.

Chapter 1 WACC

Initial comments

We focus on comments made by BA and its advisers in connection with the CAA's proposals on Heathrow's WACC (weighted average cost of capital). There is, however, read across to parallel comments made by the LACC, the Heathrow AOC and Virgin Atlantic.

BA's latest commentary on Heathrow's cost of debt contained in Annex B of its response to the CAA's Final Proposals for Q6 is best described as a selective assessment of the cost of debt across most of the topics discussed in the paper.

A few examples are highlighted below:

- With the benefit of hindsight, BA claims that customers should not pay for 2 Heathrow bonds that happen to have high coupons, inferring that entering into them reflected poor management decisions. This is disingenuous as management are incentivised to make the best decisions given a particular set of circumstances. The credibility of BA's position is further undermined given that it has a similar long-dated 8.75% coupon sterling bond issued in 2001 and maturing in 2016;
- Seeking to take advantage of the benefits of Heathrow's whole business securitisation structure where it could deliver a lower cost of debt but distancing itself from it where the reverse might be true. For example, the suggestion that the CAA should only be using A rated benchmark indices to assess Heathrow's cost of new debt when the CAA explicitly targets a rating based on the notional capital structure more at the BBB+/BBB level.

Given the self-serving nature of the commentary, it is perhaps not surprising that BA does not, for example, question the forward curve adjustment used in deriving the cost of new debt where Heathrow's responses to both the Initial Proposals and Final Proposals made clear there is no rational argument for using any other gilt to corporate bond yield coefficient than 1.0 (and neither, do we note, did the Competition Commission make any such argument in the recently published NIE Preliminary Decision). It is telling that BA appears to willingly accept a methodology that is clearly in its favour.

Financeability

BA's response also completely ignores the fundamental fact that even after increasing the cost of debt allowance in the Final Proposals versus the Initial Proposals, the CAA's own analysis demonstrates that Heathrow will have no flexibility to absorb downside shocks in Q6 without a high probability of a ratings downgrade due to the level of PMICR.

This fact was underlined by Fitch Ratings in its Heathrow ratings report of 26 June 2013 in which it made clear that "should the final determination be even lower [than the Initial Proposals], a downgrade could be justified". The CAA should be in no doubt that this language is clear code for the fact a downgrade will happen as rating agencies tend to use toned down language in these circumstances as they do not want to be seen to be overtly pressuring regulators.

The whole assessment of the cost of debt needs to take this backdrop into account given the CAA's duty to ensure Heathrow can finance its operations.

Airline view & reference	Heathrow's position
Cost of debt	
<p>Ref: BA - Page 11</p> <p>“British Airways has a number of issues with the CAA’s analyses and decisions relating to the cost of debt.”</p>	<p>BA has provided its own new analysis of Heathrow’s cost of debt. Much of this is based on data on Heathrow’s actual debt. However, it is important to remember that economic regulators (and the CAA in particular) typically use evidence on a combination of yields on investment grade rated benchmark debt and/or those of comparable companies, as well as on company specific traded bonds. While the yield on company specific bonds might be different to comparable evidence from benchmark indices, reliance on broader market evidence is consistent with the view of a notional financing structure which is less focussed on company specific financing arrangements.</p>
<p>Ref: BA - Technical Annex B - pages 16-18</p> <p>Various arguments that PwC miss-assessed the appropriate benchmark indices.</p>	<p>Its commentary on page 18 on the implications for index selection, BA focuses on potential upward bias from use of BAML indices that may include financial companies given elevated spreads for these companies which existed in the 2008-2012 period. However in assessing the cost of embedded debt for Q6 one should be taking index levels over the extended period of time (1996-2012) when existing bonds were issued, whilst for new debt the focus is simply on current yields (when spreads on financials have returned to corporate levels).</p> <p>We also note that when BA criticises the Q5 cost of debt relative to the BoAML index, it focuses on real costs and does not adjust for the fact that Q5’s elevated inflation levels were not envisaged when the cost of debt was set.</p>
Cost of embedded debt	
<p>Ref: BA - Page 12</p> <p>“The CAA has made several errors in its approach to embedded debt.”</p>	<p>It should be re-iterated that the CAA’s conclusion (and the PwC conclusion on which it made reference), was not based on Heathrow’s own embedded cost of debt alone. Rather, it also looked at the return on appropriate BBB and A rated corporate debt indices, which showed higher yields. PwC say:</p> <p><i>“Our proposed range is lower (or close to the bottom-end) compared to the average yield</i></p>

	<p><i>over the last five years on benchmark BBB and A rated indices...²</i></p> <p>Therefore, other than treatment of non-sterling debt (discussed below), PwC's analysis has broadly reached the correct cost of embedded debt, and inclusion of the refinancing bonds was a legitimate component of the optimal funding structure.</p>
<p>Ref: BA - Page 13</p> <p>"The CAA has included the full cost of bonds issued as part of a refinancing in 2008."</p>	<p>It is a matter of public record that there was an uplift in spreads of either 10bp or 70bp applied to 'legacy' bonds involved in the 2008 refinancing.</p> <p>There are two inter-related reasons why this cost should be included in assessing Heathrow's cost of embedded debt:</p> <ul style="list-style-type: none"> • suggesting that coupons on bonds originally issued by BAA plc, a business that was operationally and financially diversified well beyond Heathrow, should apply to Heathrow only bonds is disingenuous; • the need to look at credit ratings in the context of the real world and the regulatory world with a notional capital structure. <p>The legacy bonds were originally issued by BAA plc prior to the 2006 acquisition by the Ferrovial-led consortium when it was a business with an operational and financial profile diversified well beyond Heathrow. When the legacy bonds were issued, BAA plc enjoyed AA-/A+ credit ratings. By the time of the refinancing, all the non-UK assets of BAA plc had been or were being sold and it was also known that Gatwick and Stansted were highly likely to be sold, substantially narrowing the business profile down to Heathrow only.</p> <p>In addition, the CAA should note that post-refinancing, credit ratings moved to A-, still above the ratings level that the CAA is targeting based on the notional capital structure. And therefore by implication still with a cost that should be slightly better than that achievable using the notional capital structure.</p>

² PwC, "Estimating the cost of capital for designated airports, A report prepared for the CAA", October 2013. See page 34.

	<p>Further a 70bp adjustment for a 3 notch change in credit ratings appears reasonable given the CAA/PWC view of a 25bp adjustment for a single notch difference.</p> <p>Finally, on page 25, BA implies the 2008 refinancing was a quick route to paying dividends and yet it is public that the refinancing specifically prohibited dividends until over £3 billion in loans had been repaid that would clearly take say 2 years to occur</p>
<p>Ref: BA - Page 13</p> <p>“The CAA has wrongly taken into account the cost of subordinated debt”.</p>	<p>In assessing Heathrow’s cost of debt for the Final Proposals, Heathrow’s assumption is that the CAA/PWC ignored its subordinated debt tranches having assessed that their average coupon was in line with the average senior debt coupon, albeit they had a shorter tenor.</p> <p>This was arguably an appropriate approach to adopt as subordinated debt is the part of the actual capital structure where leverage exceeds the notional capital structure. As far as British Airways’ concern on tenor is concerned, it might be appropriate to adjust for that once through taking into account the non-sterling denominated senior bonds – see discussion below under ‘<i>Adjustment due to matching maturity profile</i>’ – and reflect the maturity profile of Heathrow’s senior debt but certainly not twice through trying to bring subordinated debt tranches into the analysis as well.</p> <p>Further, the methodology adopted by BA in assessing what adjustment might be made for a subordinated debt cost premia is inappropriate. Embedded debt costs are based on cost at issuance whilst BA argue for the use of average subordinated debt premia over the last 3 years. Demonstrating how inaccurate this methodology is, the 2 Heathrow Finance bonds were issued with an average yield premium to Heathrow Funding senior debt of 270bp rather than the 326bp used by BA.</p>
<p>Ref: BA - Page 13</p> <p>“The CAA has erred in its treatment of non-sterling debt. Entirely excluding non-sterling debt has the effect of significantly increasing the average tenor of HAL’s debt...As the cost of debt is greater for longer tenors, all else</p>	<p>In relation to the treatment of non-sterling debt, it is true that this tends to have a shorter tenor. This is to be expected because of additional risk from currency fluctuation (reflected in progressively higher hedging costs for longer dated non-sterling debt). In fact non-sterling debt is only available for a maximum tenor of</p>

<p>being equal, this exclusion of non-sterling debt artificially inflates the cost of HAL's embedded debt."</p>	<p>10 years. So adopting non-sterling debt naturally pushes the average tenure to shorter than it would otherwise be.</p> <p>To the extent that one wanted to ensure that the cost of embedded debt more closely reflect Heathrow's actual embedded debt maturity profile, an adjustment might be justified. However, Heathrow has concerns about the overly complex adjustment methodology that BA outlines on pages 28-31 of Technical Annex B, not to mention introduction of estimates errors in the regression analysis.</p> <p>Why not simply take the dates of non-sterling issuance by Heathrow, look at the maturity of the relevant bond and derive a sterling yield from an equivalent duration Heathrow bond outstanding at the same time? A very simple straightforward method. For example, for the 6 year € denominated bond completed in 2010, if one took the yield on the 2016 £ denominated bond outstanding at that point in time, one would derive a cost of 4.99% (including actual average cross-currency swap costs incurred across Heathrow's non-sterling bond portfolio) compared to the 4.26% suggested by BA. Applying this methodology across the whole portfolio of non-sterling bonds reduces BA's suggested 37bp adjustment by 21bp.</p>
<p>Cost of new debt</p>	
<p>Ref: BA - Technical Annex, Annex B, pages 31-35</p> <p>BA's critique of the cost of new debt.</p>	<p>BA again focus on sub-ordinate debt. Confusingly on both pages 35 and 40 BA seems to be attributing a 130bp cost of debt reduction just to the removal of subordinated bonds whilst on page 31 it attributes just 55bp in relation to the cost of embedded debt. In a nominal structure it is difficult to understand why there should be a difference between the two.</p> <p>The integrity of this section of the Annex B is further undermined by the fact that on page 33 it claims that the 2 year average yield on 15+ year Heathrow bonds (all rated A-) has declined from 5.2% (as per Table 7.4 of the PWC document) at 27 June 2013 to 4.7% at 18 October 2013. Heathrow's assessment indicates that this figure has actually declined from 5.2% to 5.0% over the indicated time</p>

	<p>period. Similarly Heathrow sees the spot yield of this maturity bucket of bonds at 3.5%, once more 30bp above BA's figures. In the 10-15 year maturity bucket, Heathrow sees a spot rate that is a full 50bp higher than BA suggests. The repetition of significant errors across the various time periods and maturity buckets severely undermine this analysis and means it has little if any credibility.</p> <p>Further, BA's approach to assessing Heathrow's cost of new debt appears self serving by suggesting the CAA focuses on A rated benchmark indices due to the ratings benefits of Heathrow's whole business securitization financing. Meanwhile, for the notionally financed airport, the CAA is clear that it is focused on the airport operator achieving a 'solid investment grade credit rating' which it has indicated is BBB+/BBB. At this rating level the cost of debt is clearly materially higher.</p> <p>There is a further element of doubt caused by apparently combining the removal of subordinated bonds with using different spot dates and time periods (versus Table 7.4 in the PwC document) in the table on page 33 of the BA document. It maybe that the 130bp adjustment is due to a combination of these two effects given the average of the figures in the final column is close to 130bp (it actually is 117.5bp on a simple average basis).</p>
<p>Cut-off date for cost of debt</p>	
<p>Ref: BA - Technical Appendices - Annex C</p> <p>Annex C of BA's response contains a note by CEPA commenting on the CAA's choice of cut-off date.</p>	<p>CEPA correctly point out the sensitivity of the choice of cut-off date to the cost of new date. It is for this same reason that Heathrow, in its own response to the FP, suggested that the CAA base its final decision on an average of rates over the previous 3 months, in order to avoid dependency on spot rates.</p> <p>However, Heathrow is concerned about BA's inference that PwC has selected the date (27 June 2013) when the cost of debt and forward estimates has been at its highest for the year. This is wrong. On cost of debt it was only highest if one looks at real yields rather than the nominal yields that PwC focuses on. Further, the claim that the forward estimates</p>

	<p>are also the highest is clearly at odds with PwC's assessment given they referenced a 100bp forward curve adjustment at the time of the IP but just 90bp for the FP. Heathrow sees the forward curve adjustment currently at more like 95bp.</p> <p>Finally, BA's approach seems contradictory in that despite submitting the arguments made by CEPA for not relying on a single point cut-off as Annex C of their submission, BA do precisely this in Annex B (page 33) where they calculate the cost on Heathrow's new date based in a single cut-off of 18th October.</p>
<p>Inflation assumption</p>	
<p>Ref: BA - Technical Appendices - page 10</p> <p>"British Airways agrees with the CAA's conclusions that PwC's assumed inflation rate of 2.8% is no longer valid."</p>	<p>We note that that CC assumed an inflation rate of 2.8% (range of 2.7-3.2%) in its Preliminary Findings for NIE published on 8th November 2013.</p>
<p>Cost of equity</p>	
<p>Ref: BA - Page 14</p> <p>"British Airways and its consultants have previously produced evidence for the CAA that the equity beta for Heathrow is less than one."</p>	<p>BA has provided no new argument on Heathrow's cost of equity. BA believes that Heathrow's equity beta is "unambiguously" less than one. It is impossible to understand how such a definitive conclusion can be reached in the light of all the benchmarking (e.g. by PwC and Europe Economics) and fundamental analysis modelling (by Europe Economics), not to mention 3rd moment CAPM modelling (by Europe Economics)³, that all points to a Heathrow beta greater than one. In any case, a company's equity beta is a function of its gearing. Heathrow's 60% notional gearing is relatively high compared to most quoted companies, and so an equity beta of greater than one should not be unexpected.</p>

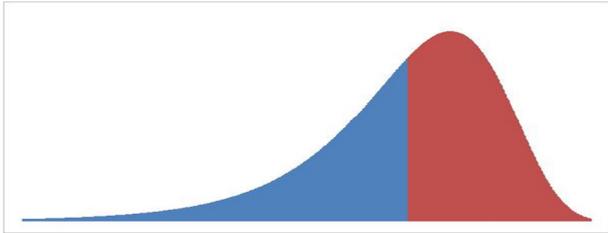
³ Q6-Price Control Review —the Cost of Capital of Heathrow Airport, *A Report from Europe Economics on Behalf of Heathrow, August 2012*. See paragraphs 6.26 onwards.

Chapter 2 Forecasts

Airline view & reference	Heathrow's position
Updates to the forecast	
<p>Ref: BA - Page 21</p> <p>“Firstly, any responsible regulator will wish to ensure that its final decision reflects the most up-to-date information available to it”.</p> <p>[Whilst BA's comment refers to forecasts Heathrow considers that the same principle might also be applied to other building blocks].</p>	<p>The responses of BA and the LACC to the CAA's Final Proposals on forecasts provide little or no new substantive arguments other than the need to update the forecast. We agree, and continue to review forecasts on a twice yearly basis, taking account of the latest economic, capacity and performance data. Consequently we are updating the forecast, and are due to discuss the outcome with the wider airline community at the end of November. The new forecasts proposed by both BA and the LACC are gross over-estimates for two principal reasons:</p> <ol style="list-style-type: none"> 1. The forecasts made by BA and the LACC make no allowance for shocks. 2. BA and the LACC apply their growth rates to the raw 2013 traffic figure without any consideration of whether this is a suitable base for a long term forecast.
Recent traffic statistics and relevance to long term forecast	
<p>Ref: LACC - Section 6, page 43</p> <p>“HAL's traffic growth has continued to outperform previous assumptions.”</p> <p>Ref: BA - Page 21</p> <p>“Traffic at Heathrow is healthy, and the latest announcement shows a record highest ever rolling 12 month traffic figure of 71.9m.”</p> <p>Ref: BA - Page 21</p> <p>“It has been suggested by the CAA that there is likely to be a decline in traffic between 2013 and 2014 and nor is that credible.”</p> <p>Ref: LACC - Section 6.1, page 43</p> <p>“The base year of the forecast (2013/14) has a significant impact on the overall level of traffic over the quinquennium. Since the ACC provided its last assessment, traffic at Heathrow Airport has shown much stronger</p>	<p>There is a long history of getting this wrong. Using a single base year carries a potential risk for the accuracy of long-term forecasts. Forecasts that are not aligned to the underlying growth at Heathrow may either under or over-represent passenger numbers, particularly if the peak or trough of the cycle were used as the base year. Given the past 4 consecutive years of strong growth Heathrow is now reaching past the mid-point of its aviation cycle. A recent IATA report supports this: “IATA's forecasts for 2013 and 2014 indicate an industry that is moving from a mid-cycle margin in 2012 to levels in the upper range of the cycle.” Even excluding shocks, traffic moves through significant peaks and troughs. Over the last 15 years at Heathrow, and after removing the adverse effect of shocks, one year in three has experienced a decline in traffic relative to the previous year. On average the de-shocked traffic decline in these five years has been -1.1%, but it has varied from – 1.4% to –0.6%. Capacity has declined on three occasions. If 2014 is another growth year it</p>

<p>growth than forecast. Moreover, it is also significantly outperforming the growth assumed in the CAA's Final Proposals."</p> <p>Ref: BA - Page 21</p> <p>"British Airways believes these forecasts to be an underestimate, not least because the starting base for the forecast is too low compared to current volumes."</p>	<p>would represent 5 years of consecutive growth, something not seen since the 1990s. The higher than expected growth in 2013 has been driven by a combination of cyclical and 'one-off' factors. There has been an increase in GDP growth through the recovery period of the current business cycle and an increase in seat capacity as we transition towards the peak of the aviation cycle. One-off factors include a short term increase in tourism as a result of the Olympics, an increase in bookings due to the coldest and wettest winter on record in the UK, airlines searching for volume during the transition period of Lufthansa's disposal of bmi and fewer lost passengers as a result of adverse weather or operating conditions.</p>
<p>Accuracy of the passenger forecast over the entire Q</p>	
<p>Ref: BA - Page 22</p> <p>"...the fact that current traffic levels are significantly higher than forecast by HAL's econometric model for the first three years of the control must call into question the robustness of the model and its accuracy as a predictive tool."</p>	<p>For the reasons given above, this single data point does not suspend the use of a model built to provide a forecast over a 5 year period. We remind BA that Heathrow and airlines, with the close involvement of the CAA, have worked more rigorously and collaboratively than ever before to jointly create and refine a passenger forecast using the econometric model. It has been peer reviewed and endorsed in both 2011 and 2012 by Dr John Bates at the airlines request, and the resulting report provided broad support for the methodology, modelling technique and key assumptions. The CAA has stated that the traffic forecast should be "the best estimate of mean passenger numbers during the forecast period" and we are confident the model produces this.</p>
<p>Inclusion of shocks</p>	
<p>Ref: BA - Page 19</p> <p>"British Airways objects to the inclusion of a shock generator in the passenger forecasts".</p>	<p>Heathrow has consistently argued that allowance needs to be made for shocks in order to achieve an unbiased forecast, given the unique capacity constraints it faces. The independent review by Dr John Bates concurred with this view. Airlines have attempted to argue that shocks are over-estimated by sub-optimal response to snow events, but the December 2010 snow event was excluded from Heathrow's shock estimation since lessons have now been learned and Heathrow has a Winter Resilience programme to respond to any disruption due to</p>

	snow. It is worth noting that the apparent decline in traffic in 2014 (referred to on page 21 of the BA Response) is simply the shock adjustment of moving from 2013 (where there were no shocks) to a forecast year where we allow for a possible shock.
The inclusion of shocks double counts the demand risk	
<p>Ref: LACC - Section 6.2, Page 44</p> <p>“The Airline Community does not believe that the CAA has made the case for changing the way in which it accounts for demand risk. There is a strong risk of double counting this risk”.</p> <p>Ref: BA - Page 18</p> <p>“The CAA’s assertion that traffic risk can be broken down into two parts is new. However, to the extent that demand shocks were included in the calculation of the Q5 asset beta then the inclusion of a shock generator must be double counting.”</p>	<p>Heathrow’s position remains the same. The inclusion of shock methodology with the passenger forecasts does not double count the risk. Forecasts provide for the expected outcome (with an appropriate measure for shocks). The WACC reflects the risk around this expected outcome (including systematic asymmetric risk).</p>
Size of demand shocks	
<p>Ref: LACC – Section 6, Page 43</p> <p>“the airline community continues to dispute both the inclusion of adverse demand shocks as well as their nature and scale.”</p> <p>Ref: BA – Page 19</p> <p>“In summary, British Airways maintains its view that the CAA has not adequately considered what size of shock to include in the traffic forecasts.”</p>	<p>The size of shocks has been calculated using the shock model and has been independently verified by Dr. Bates. Heathrow’s position remains that shocks should be calculated from 2000, as Heathrow has effectively been capacity constrained since 2000/2001.</p>
<p>Ref: BA - Page 19</p> <p>“...not all shocks are negative”.</p>	<p>Heathrow’s capacity constraint means that shocks will be negative. We have also firmly refuted the LACC’s analysis purporting to show recapture of shocks in our response to the LACCs response to the Initial Proposals.</p>
<p>Ref: BA - Page 19</p> <p>“...the impact of shocks such as snow could be exacerbated by sub-optimal response...”</p>	<p>The December 2011 snow event was excluded from Heathrow’s shock estimation (since lessons have now been learned), and previous shock events in 2009/10 constitute less than 5% of the overall shock effect.</p>

Shocks for other airports and NATS	
<p>Ref: BA - Page 18</p> <p>“We also note that if the CAA is correct in its assertion, then we would logically expect to see the inclusion of adverse shock generators in the traffic forecasts for LGW, STN and NATS.”</p>	<p>The impact of shocks on Heathrow is unique because of its binding capacity constraint throughout its whole period of operation. LGW and STN both have capacity to recapture lost traffic. NATS price control includes a traffic risks sharing mechanism.</p>
Risk	
<p>Ref: BA - Page 20</p> <p>“Provided the forecast is free from bias, then the risk is symmetrical...”</p>	<p>BA argues that an unbiased (i.e. de-shocked) forecast must have symmetric risk. This is incorrect. The figure below shows a non-symmetrical distribution with the line between the red and blue areas indicating the unbiased forecast. It is clear that the risk remains asymmetric, with greater downside than upside exposure.</p> <div style="text-align: center;">  </div> <p>Heathrow is capacity constrained, therefore, there is a much greater chance of Heathrow losing traffic than gaining it because it is already full, even when the central forecast makes allowance for shocks. The maximum growth in ATMs is a few thousand whereas the downside exposure is much greater.</p>
Primacy should be given to the capacity model for 2 – 5 years of the Q	
<p>Ref: LACC - Section 6, Page 43</p> <p>Primacy should be given to the capacity model, for at least the first 2 years of the Q.</p> <p>“We argue that this should be extended and the unshocked, corrected version of the capacity forecast is most appropriate during the first three years of the forecast (and the first two years of Q6).”</p> <p>Ref: BA - Page 20</p>	<p>BA and the LACC repeat their preference for the capacity model. Heathrow’s views remain the same. The capacity model is susceptible to airline gaming and should not be given primacy over the econometric model. The structurally optimistic bias of the schedule based capacity forecast and the significant short term capacity flexibility available to airlines means that the econometric forecast is a more reliable model over a five year period. Even in the short term there are numerous factors that could lead to airlines reducing capacity, including higher fuel prices, higher taxes, adverse movements in</p>

<p>“British Airways renews its call for the CAA to base its traffic forecasts for Heathrow on the capacity model, or at least to be consistent with its treatment for Gatwick and use the capacity model for the first three years.”</p>	<p>exchange rates, and delays to aircraft deliveries.</p>
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Chapter 3 Opex

Airline view & reference	Heathrow’s position
<p>SDG opex study</p>	
<p>Ref: BA, page 25</p> <p>“Initially, the CAA’s own consultants, SDG found a scale of opex inefficiency at HAL that was consistent with the airlines own findings”.</p>	<p>This statement is not correct. BA’s position paper of January 2013 set out an unsubstantiated view of £1,260m. This estimate is markedly different to SDG’s proposed core efficiencies during Phase 2 of the studies. For example, SDG’s Phase 2 proposed core efficiencies for other operating costs and maintenance costs was, £87m and £32m, respectively.</p>
<p>Ref: BA, page 25</p> <p>“It now appears that after the publication of the Initial proposals, SDG were asked by the CAA to revisit their opex studies. Neither the airline community nor British Airways were aware that these studies were taking place, and nor were we contacted by SDG or the CAA and asked to participate”.</p>	<p>This statement is incorrect. The CAA’s Terms of Reference made clear the timetable for a possible stage three of the SDG study, post business plan submission in July 2013.</p> <p>http://www.caa.co.uk/docs/78/Other%20opex.pdf</p> <p>Furthermore, Heathrow notes the wording contained in the SDG report, indicating that airlines were engaged and their responses to the CAA’s Initial Proposals also considered.</p> <p><i>“We have also taken into account comments made by individual airlines (British Airways, Virgin Atlantic and the LACC) in response to the Initial Proposals. We followed this up with discussions with both the airport and airline representatives.”</i></p> <p>Source: http://www.caa.co.uk/docs/78/SDG%20-%20Maintenance%20Renewals%20and%20Other%20Opex%20-%20Heathrow%20-%20Phase%203%20Final%20Report%20[with%20redactions].pdf</p>
<p>Ref: AOC, page 21</p> <p>“...HAL has had the whole period between the Initial and Final Proposals to work with SDG and to shape its advice”.</p>	<p>This statement is incorrect. During the third phase of SDG’s study, the scope of Heathrow’s involvement was only to respond to queries raised by SDG.</p>

Workforce strategy	
Ref: BA, page 26 “...we note that the CAA often refers to HAL’s workforce strategy. This is not a document that the airline community has seen...”	This is incorrect. The components of Heathrow’s workforce strategy are set out in the Full Business Plan and Revised Business Plan.
Q5 performance	
Ref: BA, page 26 “British Airways agrees with the CAA that over Q5 period, HAL has both exceeded its opex allowance and underestimated its potential to reduce costs”.	This selective quote misinterprets the CAA’s statement. The CAA considers that HAL “ <i>has underestimated its potential to reduce costs in response to lower passenger numbers over Q5</i> ”. Source: CAA’s Final Proposals, page 102. Moreover, during CE Heathrow presented to the airlines the “adjusted” Q5 performance against the CAA’s settlement, illustrating how Heathrow has met the CAA’s opex targets by the end of Q5. At no stage during the CE process, did the airlines comment on or disagree with Heathrow’s analysis.
Employee pay	
Ref: BA, page 27 “We do not agree with the CAA that decisions on employee pay double count decisions on opex costs elsewhere”.	We refer the CAA to Heathrow’s response to the CAA’s Final Proposals. Our submission on Helios’ central services cost study and CAA’s interpretation thereof, sets out Heathrow’s position.
Other opex	
Ref: BA, page 27 “British Airways agrees with the CAA’s proposals not to glide path the efficiency savings suggested for this area”.	We refer the CAA to Heathrow’s response to the CAA’s Final Proposals. The CAA’s considerations on the application of a glide path in the Initial Proposals clearly referred to the barriers to delivery of immediate efficiencies.
Ref: BA, page 28 “...we believe that the CAA’s decision not to include an ANS cost efficiency target is an error, and one that must be corrected”.	We refer the CAA to Heathrow’s response to the CAA’s Final Proposals. There are justifiable reasons for the level of ANS costs, in part due to the greater complexity of air traffic at Heathrow.
Maintenance costs	
Ref: BA, page 28	We refer the CAA to Heathrow’s response to the CAA’s Final Proposals. See other opex above.

<p>“British Airways agrees with the CAA’s proposals not to apply a glide path to maintenance efficiency”.</p>	
<p>Ref: BA, page 28</p> <p>“British Airways has not been able to review the additional information HAL provided to the CAA on maintenance costs benchmarking, and so is unable to respond fully.”</p>	<p>This is surprising given Heathrow’s information on maintenance costs forms part of Heathrow’s response to the CAA’s Initial Proposals, which is available on the CAA’s website.</p> <p>http://www.caa.co.uk/docs/78/HALApr13.pdf</p>
<p>Ref: BA, page 28</p> <p>“HAL have already achieved savings of 16% through outsourcing, and SDG note HAL could achieve the 25% savings from the baggage contract in other areas.”</p>	<p>This statement misinterprets SDG’s Report and the CAA’s proposals.</p> <p>SDG state HAL has achieved, “<i>for its baggage maintenance costs, a saving of 25% over Q6 across all its costs (which are mostly outsourced)... While it would be too optimistic to assume that a similar 25% saving could be made in this area, we consider it reasonable that a 12.5% saving on non-baggage outsourced maintenance costs is achievable...</i>”.</p> <p>Source: http://www.caa.co.uk/docs/78/SDG%20-%20Maintenance%20Renewals%20and%20Other%20Opex%20-%20Heathrow%20-%20Phase%203%20Final%20Report%20[with%20redactions].pdf</p>
<p>Ref: BA, page 29</p> <p>“In its Initial Proposals, the CAA noted that the maintenance budget for 2008/09-2011/12 was £429m. Turning this into a five year figure gives: £536m. Applying the HAL efficiency range would yield a maintenance efficiency target of £86m-£134m. Allowing some aiming off for wage costs accounted for elsewhere, would yield an efficiency target of around £100m – or five times the CAA’s current proposal”.</p>	<p>BA’s analysis is crude, at best. Heathrow has already provided evidence (see source below) that sets out the comparability of Heathrow’s maintenance cost per square metre.</p> <p>BA’s comment on double-counting pay costs appears to be at odds with other statements contained in the BA response (see above).</p>
<p>Ref: AOC/LACC, page 23</p> <p>“HAL has achieved savings of 16% through outsourcing and HAL has shared with the Airline Community that it expects to achieve 40% savings...”</p>	<p>Heathrow does not recognise the 40% figure referred to by AOC/LACC (no reference is provided). Moreover there appears to be no evidence supporting the 40% figure and it is questionable whether such a level of efficiencies is at all realistic.</p>
<p>2017 rates revaluation</p>	
<p>Ref: BA, page 30</p> <p>“British Airways has not been privy to the information shared between HAL’s</p>	<p>In respect of the rates revaluation, the additional information shared between Gerald Eve, the CAA and its consultants SDG is reflected in the letter attached to Heathrow’s public response to the</p>

advisers, Gerald Eve, and the CAA's Advisors, SDG, and therefore cannot comment on the CAA's decision".	CAA's Initial Proposals. This information was available to airlines shortly after publication of the CAA's Initial Proposals. http://www.caa.co.uk/docs/78/HALApr13.pdf
Other Regulated Charges	
<p>Ref: BA, page 55</p> <p>"We do not dispute the CAA statement that there is value in retaining separate charges for baggage and PRMs as discussed in section 8:19. However, these should be transparent through the maximum allowable yield price cap consultation process, and not through any Other Regulated Charge"</p>	<p>This statement conflicts with the existing regulations that require both of these charges be subject to consultation and transparency.</p> <p>We refer the CAA to the relevant CE documentation and airlines' agreement with the ORCs (as set out in Heathrow's Full Business Plan).</p>
<p>Ref: BA, page 55</p> <p>"...so we can only assume that a large proportion relates to overheads and annuities that will be reflected in an equivalent table 6-3".</p>	<p>This statement is incorrect. The £34m reflects the opex efficiency proportion to Other Regulated Charges, and is not based on annuities.</p>

Chapter 4 Commercial

Airline view & reference	Heathrow's position
Base revenues: GDP	
<p>Ref: BA Response, paragraph 5, page 9</p> <p>"CAA justifies a lower challenge on retail revenues on the grounds of slower GDP growth".</p> <p>Ref: BA Response, paragraph 3, page 24</p> <p>"it is not apparent whether the CAA regard the risk to GDP growth as being more upside or downside".</p>	<p>We refer the CAA to CAA-IR-65.</p> <p>For clarity, GDP data is an input into the econometric model used to forecast commercial revenues. The model shows that an assumed 1% growth in income in different global regions has differing impacts on categories, some positive and some negative. ✂✂</p> <p>As WDF is the largest commercial income category the positive impact of UK GDP growth on categories such as SST are offset by the negative impact on WDF.</p>
<p>Ref: Virgin Response, page 13</p> <p>"that growth in real earnings will feed into revenue growth".</p>	<p>In addition, it should be noted that Heathrow's commercial revenues are also impacted by GDP changes outside the UK. As with UK GDP these impact the commercial categories</p>

	<p>in different ways. While there may be forecast growth in some markets, in others e.g. China, it has declined.</p> <p>Taken in isolation a rise in real earnings in the UK would not necessarily lead to higher spend at the airport, c.38% of passengers are British, while another third are transfer passengers.</p>
Total Commercial Revenues	
<p>Ref: LACC Report, page 28</p> <p>“that the airline community had no opportunity to challenge the changes between FBP and RBP and no transparent and detailed explanation was provided as to why commercial revenue ceilings have fallen since the CAA’s initial proposals”.</p>	<p>Heathrow’s response to the CAA’s Initial Proposals (pages 79-81) provided a detailed breakdown of the material changes between FBP and RBP. It is therefore not correct that the airlines did not have the opportunity to challenge the assumptions on which the CAA has developed its proposals.</p>
<p>Ref: LACC Response, Page 29</p> <p>“even applying the CAA’s unchallenging average of circa £8 per passenger, this equates to £80m”.</p>	<p>This is incorrect. The £8 per passenger applied by the CAA is very challenging, it assumes that all commercial revenues including advertising and property are directly impacted by passenger volumes, which is not the case. It also fails to take into account the diminishing nature of returns from effects such as terminal congestion and capacity limits.</p>
Car Parking and PRT	
<p>Ref: BA Response, page 24</p> <p>Time difference between coaching and PRT does not warrant a price differential for car parks.</p>	<p>The T5 PRT System is in the interest of passengers, giving them a significantly better experience as evidenced by QSM scores which have increased from 3.8 to 4.7. It has also delivered a 50% reduction in emissions over diesel buses.</p> <p>There are also commercial benefits. The existence of PRT has increased demand by 10% and allowed us to charge a premium. Analysis comparing demand and pricing pre and post PRT, demonstrates that these incremental benefits are a result of PRT. PRT also provides a sponsorship opportunity to reduce aero charges.</p>
<p>Ref: BA Response, page 24</p> <p>“The car park that is served by the PRT carries the same pricing structure as the car park for the CTA”.</p>	<p>This is incorrect. There are four ‘business’ car parks at Heathrow, the CTA and T4 business car parks (with a ‘standard’ business proposition) are priced at one level, while T5 (served by the PRT) and T1 ‘Business Plus’ (served with an ‘on-demand’ transfer minibus) are priced at a higher level to reflect the</p>

	<p>enhanced service proposition.</p> <p>A growing number of passengers pre-book their car parking. The prices paid for business parking at T5 are typically higher than for the CTA. Additionally, while the roll up tariff is the same at T5 and T1 Business Plus, roll up demand is materially higher in the T5 car park.</p>
<p>LACC, BA Response page 30, LACC & page 24, BA</p> <p>"Car park projections for staff in the CTA do not reflect the commercial price that HAL are planning to charge".</p>	<p>This is incorrect. The RBP commercial revenues are not overstated as they are based on experience from previous price rises, where any increase in price is balanced by a reduction in usage.</p>

Chapter 5 Capex

Airline view & reference	Heathrow's position
Engagement on the Capital Plan	
<p>Ref: LACC - page 10 and BA - page 8 and 32 (then throughout document)</p> <p>"The airline community continues to be disappointed and frustrated by HAL's capital strike".</p> <p>"Heathrow's unilateral disengagement on capital".</p>	<p>These statements misrepresent events, recent and on-going engagement and the work that Heathrow is continuing to take forward. Following CE we have continued to work collaboratively with airlines including 19 Portfolio Stakeholder Board (PSB) meetings held so far in 2013, with one more planned before the end of the year. These have been supplemented with design working groups, and sub groups on the IFS and Triggers. In addition, Heathrow has continued with the Stakeholder Boards and Gateway Events.</p> <p>Heathrow has continued design work on projects in the £2 billion plan (RBP), as well as setting out the schedule for future gateway events. At the PSB of 4th June 2013 Heathrow stated that it would continue to respond to any airline queries and questions in relation to the £3 billion plan (ABP) and related airline plans. Design work on the elements that make up the difference between the £2 Billion (RBP) and the £3 billion (ABP) plan were recommenced shortly after publication of the CAA's Initial Proposals.</p> <p>Indeed, this recent engagement with airlines has informed and improved the capital plans in a number of ways, e.g. in the FBP, B016 T3</p>

	<p>Refurbishment was an allowance for passenger facing works. Substantive further work with the community led to the identification of a number of opportunities. Similar working has also led to improvements in the security option being progressed in T5. Extensive consultation and engagement with the community led to a greater understanding for the requirements for passenger automation and led to a doubling of the allowance from FBP to ABP.</p> <p>It is not correct to state that Heathrow has disengaged on capital discussions. As noted in our previous responses Heathrow paused all stakeholder engagement regarding the Q6 capital plan with the airline community for a period of only one month. This brief pause led to the cancellation of two PSB meetings, hardly material in the scheme of overall engagement in the last 2 years. A legitimate period of time during which Heathrow's Board assimilated the CAA's Initial Proposals.</p>
<h3>Recognition of Heathrow's Capital Plan</h3>	
<p>Ref: LACC, page 12 and 40, BA, page 32</p> <p>“there remain considerable differences between HAL's ABP and the Airline Community's proposed Capital Plan”.</p> <p>“BA does not recognise or endorse any of the capital proposals that have been put forward by HAL”.</p>	<p>These statements do not reflect the evidence.</p> <p>Heathrow's ABP has responded to both the direction given by the CAA in the Final Proposals and the ongoing engagement with airlines throughout 2013.</p> <p>On around 90% of the value of the ABP there is a significant degree of commonality, with key projects currently progressing through the Gateway process.</p> <p>Some of the difference between our plan and the Airline's can be explained by our inclusion of the CAA's direction in the Final Proposals, the remainder is due to some minor differences in T3 and T4, some major airline requirements in T5 and further differences in understanding of estimates and scope.</p> <p>Unless airlines are basing their view on a capital plan we have not seen it is histrionic and incorrect to state that Airlines do not recognise Heathrow's plans and that significant differences remain.</p>

Further T3IB write-down	
<p>Ref: LACC - Section 5.2.8 and BA page 32</p> <p>‘an additional £41.5 million in relation to T3IB has not been substantiated’.</p> <p>‘Heathrow has not consulted on the latest cost increase’.</p>	<p>Heathrow does not accept the airlines’ assertions in relation to consultation and efficiency.</p> <p>Heathrow has engaged closely with airlines and consulted with them in accordance with the obligations set out in the Enhanced Information and Consultation Protocol. Airlines were fully consulted at the relevant gateways.</p> <p>As part of our ongoing engagement beyond G3 the issue of EAC pressure has been discussed in detail through the formal Governance process at the CIPWG and Planning and Regulation Board, along with Western Baggage working Group and Baggage Stakeholder Board.</p> <p>With regard to efficiency it is important to note that by the end of Q5 the forecast expenditure on T3IB will be approximately £350m. Of that £350 million the CAA is proposing to writedown the RAB by £30m. In addition Heathrow will pay over £28m in trigger rebates. Heathrow has therefore been significantly impacted through adjustments to expenditure that amounts to almost 18% of Q5 expenditure on the project.</p> <p>Furthermore, in Q6 the forecast spend rolling over is approximately £82m. The actual expenditure on the project will not be known until the project is completed yet the airlines are suggesting that this money also be written down (ex-ante) in contradiction to the regulatory model.</p>
Construction Inflation	
<p>Ref: VS - page 13</p> <p>“VAA have clearly demonstrated to the CAA that we are able to consistently achieve a real 0% inflation in our supply chain. VAA believe that there is no reason why HAL cannot achieve the same, and we would therefore urge the CAA to revisit its position on this basis”.</p>	<p>We refer the CAA to Heathrow’s response to the Final Proposals. The CAA’s proposal appears to ignore advice contained in both the ASA and Davis Langdon reports which support Heathrow’s RPI+1% construction inflation proposal and even suggest that this may not be enough towards the end of Q6 (ASA Q6 Capex Review Heathrow Airport Draft Interim Report). Furthermore, recently published indices from BCIS, and Heathrow’s own</p>

	<p>analysis indicate a sharp jump in exposure to construction inflation in the final two years of Q6. (BCIS tender price index September 2013).</p> <p>Relating a long term investment business to the much shorter term airline model is not logical.</p> <p>Ref: Response to Final Proposals – Page 20.</p>
Capex governance	
<p>Ref LACC, 1.5 and BA, page 37</p> <p>LACC and BA welcome the CAA proposals in relation to agreement and appeal.</p>	<p>We refer the CAA to Heathrow’s response to the CAA’s Final Proposals, and Heathrow’s response to proposed CAA Guidance, 19th November.</p> <p>As demonstrated in Q5, it is always Heathrow’s intention to reach agreement with the airline community and the incentives to agree are inherent within the regulatory model. However if agreement cannot be reached following consultation, Heathrow will continue to make the final decision on investment in the interests of passengers.</p>

Chapter 6 Capital Efficiency

Airline view & reference	Heathrow’s position
On-Costs	
<p>Ref: BA - page 36</p> <p>BA again incorrectly states that “Heathrow has allowed construction contractors to earn a return of 7.5% of build price”.</p>	<p>This is incorrect. In preparing estimates for Q6 Heathrow allows for 7.5% in total, for both Contractors Overheads and Profits. The notional split for this is 5.5% overheads and 2% profit.</p>
Core and Development Capex	
<p>Ref: BA - page 37</p> <p>BA states that “it is particularly pleased that the CAA has proposed that funds generated when a project switches from P80 to P50 should be used for additional projects.”</p>	<p>This is misleading and misinterprets the CAA’s proposals. Funds can be used to balance requirements of other development projects, progress other previous unknown requirements or fund development pipeline log scope. Alternatively, the decision can be made not to invest some or all of the funds, with the development capex remuneration mechanism ensuring that Heathrow only earns a return on development capex that is taken forward. This</p>

	is consistent with the development capex principles agreed with the airline community and set out in the Capital Efficiency Handbook.
Mid Q Review	
<p>Ref: LACC 5.3</p> <p>LACC suggests that a mid-term review should take place in Q6.</p>	<p>This would be inappropriate. The introduction of the Independent Fund Surveyor avoids any requirement for a mid-Q review and also reduces the scale of the end of the end of Q review. This will reduce the administrative burden for Heathrow, the airline community and the CAA.</p> <p>It is central to the integrated capex efficiency approach for Q6 that the jeopardy of multiple reviews is removed. Indeed, Heathrow's engagement with the IFS approach was conditional upon the removal of other review mechanisms. If this is not to be the case then Heathrow will disengage with the IFS implementation. This would be disappointing as the ongoing review inherent within the IFS model would be more efficient for all parties. It cannot be the case however that the outcome of this approach is to further increase the regulatory burden.</p>
Independent Fund Surveyor	
<p>Ref: BA - page 38</p> <p>BA states that this should be an airline only appointee.</p>	<p>This is inconsistent with the agreement between Heathrow and the airline community that this is a joint appointment between Heathrow and the Heathrow AOC.</p>

Chapter 7 Service Quality

Airline view & reference	Heathrow's position
Constructive Engagement	
<p>Ref: BA -page 39</p> <p>BA refers to the "low level of change" to Heathrow's Service Quality proposals following extensive constructive engagement.</p>	<p>This is factually incorrect. Notwithstanding Heathrow's proposed Service Charter and the proposed re-configuration of the scheme, both of which were rejected by airlines in favour of retaining the status quo. Heathrow's service quality proposals have evolved throughout the constructive engagement process. Examples of changes to Heathrow's position during constructive engagement include the addition of jetty availability and the aerodrome</p>

	<p>congestion term to Heathrow's proposal.</p> <p>In addition, following CE Heathrow refined its security wait time harmonisation proposal, proposing a 99% 10 minute target, included in its Q6 Full Business Plan. It remains surprising that BA and other airlines have passed up the opportunity to implement pro-passenger measures like the removal of 'knife-edge' rebates.</p>
<p>Interim Security Slide Pack submitted by Heathrow</p>	
<p>Ref: BA - page 39, LACC 9.8</p> <p>BA and the LACC suggest that Heathrow was slow to provide a particular presentation to the airlines.</p>	<p>This is incorrect. Heathrow met with the CAA on 18 October. The CAA emailed the airline chair of the Service Quality Working Group on 23 October to advise that a discussion with Heathrow had taken place, and that the CAA had requested a set of slides from Heathrow. It asked that Heathrow provide an update at the Service Quality Working Group. On 24 October at the Service Quality Working Group, Heathrow briefed the airlines that a meeting had taken place and that a set of slides were being submitted to the CAA which would be made available to the airlines. On 28 October the set of slides was submitted to the CAA. This was made available to the airlines on the same day via BOX, with an email containing a link sent to airline attendees of the Service Quality Working Group and Planning & Regulation Board.</p> <p>It is noteworthy that airlines repeatedly assert lack of access to data when it can be clearly demonstrated that this is not the case. In contrast airlines have repeatedly demonstrated delay, lack of transparency and disorganisation in interacting with Heathrow.</p>
<p>Security Wait Time</p>	
<p>Ref: LACC 9.8 - page 62</p> <p>LACC states that security processing starts once a bag enters an x-ray machine or a passenger enters the archway metal detector, rather than at the roller bed.</p>	<p>This is incorrect. The processing of passengers for security begins at the roller bed where security officers prepare passengers to pass through the metal detectors. In addition, the regulated security process starts at the roller bed with the spacing of bags and profiling of passengers. It is surprising this is not already well understood by the airlines.</p>
<p>Ref: BA - page 42, LACC 9.8</p> <p>BA and the LACC state that Heathrow has</p>	<p>The implication of this assertion are frankly outrageous and reflect the paucity of operational understanding amongst airlines</p>

<p>installed increasingly long roller beds that allow security queues to be manipulated or artificially reduced.</p>	<p>that contribute to the regulatory process. Heathrow tends to have short security lanes and roller beds in comparison with some other airports due to terminal layouts and physical constraints. Furthermore, the length of the roller bed does not materially impact the overall security wait time, indeed, it provides for a better passenger experience.</p>
<p>Ref: LACC 9.8</p> <p>LACC states that the airline community “continues” to support a per passenger waiting standard of 8 minutes.</p>	<p>Heathrow is not aware of the LACC having communicated its support for this standard at any time in the Q6 process prior to this response to the CAA’s Final Proposals.</p> <p>This does reflect a consistent theme of confusing communication from airlines in respect of service quality.</p>
<p>Provision of Service</p>	
<p>Ref: BA - page 48 LACC 9.10</p> <p>BA and LACC propose that, should Heathrow fail to deliver an agreed level of enhanced service, or Heathrow refuses to enter into negotiations for a new service, that airlines can ask the CAA to take over provision of the service (or appoint a third party).</p>	<p>Notwithstanding that this appears to be entirely inconsistent with the LACC and BA position on a Service Charter and the development of a more commercial approach, this is a fundamental shift in airline “policy” and the first time in the Q6 process that this issue has been raised (once again).</p> <p>This would have a material impact on Heathrow’s business and in the event the CAA is minded to consider this issue, Heathrow reserves the right to submit more detailed comments and any other information, as necessary.</p>
<p>Pier Service</p>	
<p>Ref: BA - page 50</p> <p>BA proposes a pier service SQR target for Terminal 5 and refers to agreements between BA and Heathrow.</p>	<p>BA has misrepresented the joint work carried out by Heathrow and BA. The work undertaken was used to demonstrate how various constraints, both operational and facilities related, impacted upon the stand plan and whether an agreed programme of minor works and an understanding of operational efficiency improvements, could be developed to support BA optimising levels of pier service at Terminal 5.</p> <p>It was made very clear in undertaking this work that it was not intended to determine whether or not who performed the stand planning function was material to whether a 95% target could be met. It is also incorrect to state that</p>

	<p>both parties agreed that irrespective of who carried out stand planning a 95% target could not be met. The analysis was carried out using a single day in the winter schedule (the day of week which in BA's view was the most challenging) and in line with BA's own stand planning rules. This was not an exercise to forecast the level of pier service that could be achieved across the winter 2013/14 season.</p> <p>BA's proposal also refers to a methodology for calculating pier service by season, indicating that this has been agreed between Heathrow and British Airways. This is incorrect. At no time has this been agreed by Heathrow.</p> <p>BA's proposal is entirely inconsistent with the CAA's 2013 decision, which states that a pier service SQR target is inappropriate where the airport is not responsible for stand planning.*</p> <p>BA has repeatedly chosen to misinterpret the facts in relation to T5 pier service, presumably due to the commercial benefits to them in doing so. We trust the CAA sees through this and BA refocuses its efforts on delivering pier service levels that meet passenger expectations.</p> <p>* CAP 1057, April 2013.</p>
Baggage Performance	
<p>Ref: BA - page 54</p> <p>BA states that it is developing a proposal for a baggage performance SQR measure.</p>	<p>Despite CE and the CAA's previous consultations, this is the first time in the Q6 process that this issue been raised.</p> <p>It once again makes a farce of the regulatory process that BA fails to engage until such time as it suits them to do so. The regulator should discourage them from this overt game playing.</p> <p>For the avoidance of doubt such a measure could have a material impact on Heathrow's business and in the event the CAA is minded to consider this issue, Heathrow reserves the right to submit more detailed comments and any other information, as necessary.</p>

Staff Search	
<p>Ref: BA page 54, LACC 9.17</p> <p>BA and LACC refer to the quality of staff search performance at Heathrow.</p>	<p>These statements by the LACC and BA are misleading. There is no evidence of a decline in staff search performance. Heathrow has met and continues to meet the SQR target in every terminal throughout Q5.</p> <p>Also, this is the first time in the Q6 process that the issue of an interim standard has been raised. It is incorrect to describe the Q5 standard as an interim standard. For Q5 Heathrow clearly stated that any increase to the standard during Q5 would be dependent upon a more efficient use of security, including requiring changes to rostering for many staff who use the staff search facilities and sharing central search facilities to avoid additional opex and capital expenditure.</p> <p>The LACC's proposed 5 minute standard is inconsistent with the principles set out by the airlines in the outputs of constructive engagement "<i>where the airlines are proposing increases in some of the Q5 quality standards for the Q6 period the airlines recognised the need to consider the costs associated with any increases in quality.</i>" The cost impact does not appear to have been considered at all in this proposal.</p>
Changes to the Statement of Standards and Agreements	
<p>Ref: LACC 9.17</p> <p>LACC states that changes should be dependent upon the agreement of airlines.</p>	<p>While Heathrow always seeks and will continue to seek agreement with the airline community, it would be unacceptable for airlines to have a veto on changes to the Statement of Standards and Agreements.</p>
Deadband	
<p>Ref: LACC 9.11</p> <p>LACC welcomes the fact that the draft licence appears to rule out any other periods being included in the deadband period other than the specific months listed.</p>	<p>The draft Q6 licence is inconsistent with the Q5 settlement which includes "a month agreed to in writing for that the relevant asset or element and terminal by the airport and the AOC".</p> <p>The removal of this clause would reduce flexibility in Q6 and in effect rule out the approach to deadband periods that has operated throughout Q5 and which was agreed with the airline community as being consistent with the interests of passengers.</p>

Fuel	
<p>Ref: LACC 9.25</p> <p>LACC states that the CAA should establish a new element in the SQR regime for Q6 and refers to a submission of 16th August.</p>	<p>The CAA set a strict deadline for responses to the Initial Proposals of 25th June 2013. Heathrow has not been made aware of additional airline submissions made after that date, nor are they available on the CAA website.</p> <p>It is not clear why the CAA has not published this particular submission. Heathrow first became aware of a proposed 'fuel' SQR on 15th November 2013.</p> <p>Heathrow is not responsible for fuel supply and does not operate in the fuel 'market'. It is a principle of good regulation that the regulatee has sufficient control over an outcome if it is achieve any targets set by the regulatory framework. Therefore the application of an SQR target in respect of fuel would be inappropriate.</p>
Security factor	
<p>Ref: LACC - 12.7</p> <p>The airline community suggests that the £20m deadband should apply to 'each occasion of extra security mandated by the Secretary of State'.</p>	<p>This proposal is disingenuous and lacks credibility. Heathrow believes that the CAA's Final Proposals are clear and the £20m deadband applies, as in Q5, to the whole of the quinquennium.</p>

Chapter 8 Other Price Control and Policy Issues

Other Regulated charges

Airline view & reference	Heathrow's position
Remuneration of Baggage and PRMs	
<p>Ref: LACC - 8.00 and BA - Page 54</p> <p>Following agreement during CE on those costs being remunerated through ORCs, the airline community, and BA in particular, have now changed their position and wish to move Baggage and PRM from ORCs into airport charges.</p>	<p>The joint decision by the NRCG and Opex workstream to retain the existing specified activities was intended to drive best value for money for all stakeholders through a mechanism that was granular enough to drive the right incentives and deliver the best experience for the passenger through joint, collaborative working.</p>

	<p>The BA response represents a significant change from their previous position.</p> <p>On numerous occasions during constructive engagement (27/9/11, 11/10/11, 25/10/11; 25/1/12, 29/3/12, 24/9/12, 22/10/12) the decision tree was discussed and the recovery of activities via aeronautical charges, other regulated charges, or commercial revenues, was agreed with the NRCG. The recommendations of NRCG were noted at the Opex Workstream meeting WS3CE May 2012 with a recommendation that the JST also agree this outcome. This was presented at the September and October 2012 JSTs. This was further ratified at the Opex Workstream meeting WS3CE September 2012. Further, the Constructive Engagement Deliverable documents notes the agreement as to the recovery of Baggage, Check in & CUSS and PRMs via ORCs during Q6 without caveat or comment.</p> <p>Heathrow does not support the change for Baggage on the grounds of cost efficiency and airline charges equity. Individual airlines have significantly different bag policies which drive cost, and different overall bag volumes per passenger. The airlines new position would be inequitable for some of their competitors.</p> <p>Heathrow does not support the change for PRMs as it would provide airlines with no incentive to ensure that PRM services are used only for the purpose intended or that pre-notification, which reduces cost, continues.</p> <p>Ref: FBP B7.1 & B7.7.</p>
<p>Staff Car parking</p>	
<p>Ref: LACC – 8.00 and BA - page 54</p> <p>The Airline community continue to challenge the income calculation for the transfer to a commercial basis of staff car parking in the CTA.</p>	<p>As per paragraph 8.6.2 of Heathrow’s Revised Business Plan, the value of income included in commercial revenues is broadly the same as that currently generated through ORCs. Total income is a combination of a commercial pass price and a forecast of the number of passes in issue. No decision has yet been made about an appropriate commercial price, however it is assumed that the additional revenue from any increase in price is offset by a reduction in the number of CTA staff passes on issue. This</p>

	<p>assumption is based on the evidence from Q5 where price increases have significantly reduced the number of passes in issue e.g. in 2010/11 there were ~2,000 passes in issue at a price of £1,900 and this has fallen in the current year to ~1,100 passes in issue at a price of £3,700. Income from passengers generated by the CTA spaces released is included within the overall Q6 car park income projections.</p> <p>LACC and BA have incorrectly assumed that a hypothetical CTA pass price of around £8,000 would not result in any reduction in the number of passes on issue. Actual experience from Q5, as described above, indicates that this is not correct.</p>
Statement of Q6 annuities & overheads	
<p>Ref: LACC – 8.00 and BA - page 54</p> <p>The airline community ‘insists’ that an equivalent of Q5’s Table 6.3 for Q6 is published by the CAA.</p>	<p>It is in the interests of all parties that an equivalent table 6.3 is published with the CAA’s Final Decision.</p>
Inclusion of Baggage projects	
<p>Ref: LACC – 8.00 and BA - page 54</p> <p>The airline community continue to question the inclusion of 5 specific baggage projects in the ORC costs and revenues.</p>	<p>Heathrow’s position on this matter is unchanged. These projects are included in both the RBP and ABP.</p>

The Licence (and market power)

Airline view & reference	Heathrow’s position
Scope and Interpretation	
<p>Ref: LACC, Page 94</p> <p>Definition of Airport Area.</p>	<p>We refer the CAA to Heathrow’s response to the CAA’s Final Proposals. The airport area must be linked to the scope of the relevant market and limited to those areas where the market power test is met. The CAA must then determine the relevant operator of the area in accordance with section 9(4) of the Act.</p> <p>Heathrow has provided detailed evidence to the CAA showing that it does not operate in the</p>

	<p>fuel ‘market’, the CAA has also correctly identified that Heathrow does not operate in the fuel market.</p> <p>The LACC incorrectly assume that:</p> <ul style="list-style-type: none"> • Heathrow is responsible for the delivery of all airport operation services including fuel; • because airports must have fuel farms the airport operator must be responsible; and • Heathrow controls access to the site (other than general airfield access which is a statutory requirement). <p>These assumptions are flawed. Moreover, there are examples of non-RAB based funding mechanisms in relation to the provision of fuel infrastructure. It is clearly not the role of regulation to force companies into markets that they do not operate in, or to hold them to account for activities over which they have no control.</p>
Price Control Condition	
<p>Ref: LACC, page 95</p> <p>“that any reduction in anticipated rates cost in the settlement is shared in the same 80/20 split”.</p> <p>Ref: AOC page 96</p> <p>“In the Airline Community’s response to the CAA’s Initial proposals it was noted that a “development capex adjustment” condition would need to be very specifically drafted.</p>	<p>We refer the CAA to our response to the CAA’s Final Proposals. The AOC/LACC proposal appears to misunderstand the CAA’s proposals and is inconsistent with the basic properties of the proposed “cost pass-through” mechanism.</p> <p>We refer the CAA to our response to the CAA’s Final Proposals that sets out the correct definition.</p> <p>Ref: Heathrow’s response to the Final Proposals (pages 41,71 and 74).</p>
Service Quality Condition	
<p>Ref: LACC page 99</p> <p>Detailed comments on the Statement of Standards, Rebates and Measures.</p>	<p>We disagree with the LACC’s proposal in relation to rebates, no increased regulatory intervention is required in this area. Heathrow supports 3.4 a and b of the draft licence.</p> <p>No modifications are required to the Quality of Service Monitor. During Q5 the CAA audited the field work processes in order to satisfy itself of the integrity of the data processes that sit behind QSM, and therefore the reliability of the results that input to the SQR scheme.</p>

	<p>The LACC have made a number of suggestions in relation to the Aerodrome Congestion Term (ACT). It is not clear what the LACC are proposing so further explanation would be required if the CAA were minded to consider this proposal.</p> <p>Heathrow rejects the LACC proposals in relation to 'dead bands'. This issue is addressed in detail in the SQR section.</p>
Operational Resilience Condition	
<p>Ref: LACC, page 104 onwards</p> <p>The LACC do not accept that rules of conduct should be incorporated into the Conditions of Use or the Groundhandling Licence.</p>	<p>The Conditions of Use and the Groundhandling Licence are the established mechanisms for implementing rules at the airport. The rules of conduct are ultimately enforceable.</p> <p>Heathrow notes that in order to effectively influence and change current behaviour the airport will need to have the ability to enforce rules of conduct. The proposed requirements that have been set out in the current consultation have been discussed with the CAA. The CAA is also party to the current consultation on the Conditions of Use and Groundhandling Licence and should be in a position to offer its opinion on those rules, supported by any guidance it issues, to inform both Heathrow and the airline community of its expectations.</p> <p>Heathrow notes that any agreements that exist outside of this process will have no legal force and will do little to influence the behaviour of third parties. If the CAA adopts this route it will need to remove condition D2.14 and tighten condition D2.1 to make it clear that the purpose of the condition is limited only to 'airport operation services' for which Heathrow has direct control.</p>
<p>Ref: BA, Page 62 onwards</p> <p>British Airways requests that the CAA include binding rules of conduct in the licence in relation to HADACAB with responsibility placed on Heathrow to oblige carriers to comply with this activity.</p>	<p>Currently HADACAB processes and arrangements are voluntary although Heathrow may mandate capacity reductions on safety grounds, and has used safety as a ground to mandate short term capacity reductions at HOEC in anticipation of high winds. Heathrow is happy to support a more compliance based approach in so far as does not expose Heathrow to liability.</p>

Financial Conditions	
<p>Ref: LACC, Section 11.6</p> <p>The LACC seeks a licence condition in relation to future policy statements on the matter.</p>	<p>The LACC appear to misunderstand the purpose of a licence. Policies and statements in relation to regulation should not be included in a formal licence but in underpinning guidance on policy documents.</p>
Provision of Information and Consultation	
<p>Ref: LACC, Page 108 and BA Page 58</p> <p>British Airways and the LACC propose a more detailed condition on Heathrow in relation to consultation and information provision.</p>	<p>In accordance with the current draft condition Heathrow intends to commence consultation on governance arrangements for Q6. Heathrow rejects the CAA's position in relation to 'agreement' and the proposed appeal process as outlined above and in Heathrow's response to the CAA's Final Proposals.</p> <p>Ref: Heathrow's response to the CAA's Final Proposals (Page 119).</p> <p>Ref: Heathrow's response to proposed CAA Guidance, 19th November.</p>
Non-discrimination	
<p>Ref: LACC, page 110</p> <p>LACC call for imposition of non-discrimination condition.</p>	<p>The LACC appear to misunderstand the new regulatory framework. Section 41 of the Airports Act was repealed earlier this year. The CAA has concurrent competition powers which would provide the appropriate means to deal with discrimination issues.</p> <p>Ref: Heathrow's response to the CAA's Initial Proposals (Page 120).</p>

